

Legal analysis to guide the mortgage industry and protect its interests.

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## More Regulation for Subprime and Alt-A Loans -- The Creation of the "Higher-Priced Loan"

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On July 14, 2008, the Federal Reserve Board approved a series of final rules to amend Regulation Z, which implements the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA), in order to protect consumers and promote responsible lending. The final rules are chiefly based on a proposal made by the board in January 2008. Before finalizing the rules, the board considered testimony, public hearings, consumer testing and nearly 4,700 comment letters. The new rules impose several important changes. First, they create a new category of mortgage loans — "higher-priced mortgage loans" — and apply four protections to these types of loans. Secondly, the rules ban certain potentially deceptive or misleading advertising practices. Thirdly, they apply two new protections to every mortgage loan, even if the mortgage does not meet the definition of higher-priced mortgage loans. Finally, the rules require creditors to provide transaction-specific early mortgage disclosures. These new rules are prospective only and become effective October 1, 2009, unless otherwise provided.

### Higher Priced Loans

#### Definition

The final rules create a new subset of mortgage loans: "higher-priced mortgage loans." These loans are defined as a consumer credit transaction secured by the consumer's principal dwelling for which the annual percentage rate exceeds 1.5 percentage points of the board's published average prime offer rate for a first lien loan and 3.5 percentage points above this index for a subordinate lien loan. Initially, the proposed benchmark rate for these loans was an interest rate that exceeded the yield on comparable Treasury securities by 3 percentage points for first lien loans and by 5 percentage points for subordinate lien loans. Instead, the final rules incorporate the average offer rates for the lowest-risk prime mortgages as the threshold. These average prime offer rates will be derived from the Freddie Mac Primary Mortgage Market Survey®, and the board will publish these rates on a weekly basis. Thus, this metric will capture all loans in the subprime market and a portion, if not all, of the loans in the Alt-A market. The rules also exclude certain types of transactions from this definition. For example, home equity lines of credit, reverse mortgages, construction-only loans and bridge loans of 12 months or less are excluded from this category and are not subject to the additional protections set out below.

#### Protections

##### 1) Repayment ability

Under the new rules, creditors are prohibited from extending a "higher-priced mortgage loan" (or any HOEPA loan) based on collateral without first considering the debtor's repayment ability. Repayment ability should be determined on current and expected income, employment, assets other than the collateral, current obligations and mortgage-related obligations, such as property tax and insurance. In making this determination, a creditor is specifically authorized to rely on W-2 forms, tax returns, payroll receipts and records from financial institutions. However, when creditors extend new credit to an existing customer, they are not required to gather information previously collected if the creditor believes that there has been no change since the initial verification.

A creditor is presumed to have complied with this provision if it satisfies each of the following requirements:

- Verifying repayment ability
- Determining the consumer's repayment ability using largest scheduled payment of principal and interest in the first seven years following consummation and taking into account property tax and insurance obligations and similar mortgage-related expenses
- Assessing the consumer's repayment ability using either the ratio of total debt obligations to income (debt-to-income ratio), or the income the consumer will have after paying debt obligations (residual income).

The new rules also do not include the phrase "pattern or practice" when referring to failure to verify repayment ability. Thus, a creditor may violate the rules without engaging in a practice of failing to verify repayment ability.

##### 2) Escrows for taxes and insurance

Under the final rules, a creditor is prohibited from extending a first-lien higher priced mortgage loan secured by a principal dwelling without establishing an escrow account for property taxes and homeowners insurance. A creditor may, however, allow a consumer to cancel this escrow account 12 months after consummation of the transaction. Loans secured by cooperative shares are excluded from this requirement, if the cooperative association pays property tax and insurance premiums. Similarly, loans secured by condominium units are exempted from requiring escrow of insurance premiums if the condominium association obtains insurance through a master policy. Because of the time that may be required for servicers to develop or outsource these escrow services, this provision does not become effective until April 1, 2010. Furthermore, the effective date for this provision for all covered loans secured by manufactured housing is extended even further until Oct. 1, 2010.

##### 3) Prepayment penalties

The final rules prohibit a prepayment penalty on a higher priced mortgage loan (or any HOEPA loan) if the payments can change during the four years after consummation. For other higher priced loans whose payments do not change after the first four years, the final rules limit the prepayment penalty period of two years following consummation and require that a prepayment penalty not apply if the same creditor (or its affiliate) refinances the loan.

##### 4) Evasion through bogus open-end credit

Finally, the final rules prohibit creditors from structuring a transaction that does not meet the definition of "open-end credit" as a home equity line of credit or a "higher-priced mortgage loan" to evade HOEPA.

### Provisions applicable to all mortgages

In addition to creating the new category of loans discussed above, the new rules also establish certain protections applicable to all mortgage loans, as long as the loan is secured by the consumer's principal dwelling. For example, the final rules prohibit creditors and mortgage brokers from coercing, influencing or otherwise encouraging an appraiser to misstate or misrepresent the value of a consumer's principal dwelling. Furthermore, creditors are also prohibited from extending credit based on an appraisal when they have notice of a coerced appraisal either before or at the consummation, unless the creditor acts with reasonable diligence to determine that the coerced appraisal did not materially misstate or misrepresent the value of the dwelling. However, the rules do not prescribe specific due diligence procedures which would be considered adequate.

The final rules also prohibit certain servicing abuses. First, the rules prohibit a servicer from failing to credit a periodic payment on the date received. Secondly, the rules also prohibit the practice of "pyramiding" late fees or delinquency charges, which occurs when a fee or charge is imposed as a result of the consumer's failure to include in a current payment a fee or charge incurred on earlier payments. Finally, the rules prohibit a servicer from failing to provide a current schedule of servicing fees and charges, as well as a payoff statement, within a reasonable time after the consumer requests that information.

### Advertising

The final rules additionally amend the advertising rules for open-ended home equity plans and for closed-end loans secured by the principle residence. Most notably, the rules:

- Modify when an advertisement is required to disclose certain information about income tax implications
- Require the use of the term "promotional" rather than "introductory" to describe certain open-end credit rates or payments applicable for a period less than the term of the loan, as well as excluding the requirement that promotional rates or payments include the term "introductory"
- Exclude radio and television advertisements for home-equity plans from the requirements regarding promotional rates or payment;
- Allow advertisements for closed-end credit to state that payments do not include mortgage insurance premiums
- Remove the prohibition of the use of the term "financial advisor" by a for-profit mortgage broker or mortgage lender.

The final rules also prohibit the use of the term "fixed" to refer to a rate or payment that can vary over time.

### Disclosures

For certain covered transactions, creditors were already required to provide "good faith estimates" of the "mortgage loan disclosures" at the earliest of the extension of credit or no later than three business days after receipt of the consumer's written application. The final rules require that these disclosures be delivered to the consumer earlier in the mortgage transaction. Specifically, the final rules require that creditors give consumers transaction-specific loan disclosures for closed-end loans secured by a consumer's principal dwelling, including refinancings, home equity loans, other than home equity lines of credit, and reverse mortgages. Creditors are required to deliver these early mortgage loan disclosures no later than three business days after the application, but before the consumer pays a fee to any person (other than a reasonable fee for obtaining credit history). These disclosures should include the APR and payment schedule for the entire term of the loan.

In sum, these new rules will impose a significant burden on creditors, which will translate into higher borrowing costs for many Americans. As a result, many consumers will be pushed out of the housing market.